Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
AT&T Corp.	)	RM No. 10593
	)	
Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services	)	

Declaration of
Michael D. Pelcovits
On Behalf of
WorldCom Inc.

I. Qualifications

My name is Michael D. Pelcovits. I am a Principal of the consulting firm Microeconomic Consulting & Research Associates, Inc. ("MiCRA"), which specializes in the analysis of antitrust and regulatory economics. My business address is 1155 Connecticut Avenue, Washington, D.C. 20036.

I joined MiCRA in October 2002. Prior to this, I was Vice President and Chief Economist at WorldCom. In this position, and in a similar position at MCI prior to its merger with WorldCom, I was responsible for directing economic analysis of regulatory and antitrust matters, before federal, state, foreign, and international government agencies, legislative bodies, and courts. Prior to my employment at MCI, I was a founding principal of the consulting firm, Cornell, Pelcovits & Brenner. From 1979 to

1981, I was Senior Staff Economist in the Office of Plans and Policy, Federal Communications Commission.

I have testified or appeared before the Federal Communications Commission, many state regulatory commissions, the Office of Telecommunications (Oftel) of the UK government, the European Commission, the Ministry of Telecommunications of Japan, and the Civil Aeronautics Board. I have lectured widely at universities and published several articles on telecommunications regulation and international economics.

I hold a B.A. from the University of Rochester (*summa cum laude)* and a Ph.D. in Economics from the Massachusetts Institute of Technology, where I was a National Science Foundation fellow.

II. **Introduction**

I have been asked by WorldCom to respond to the Declaration filed in this proceeding by Alfred Kahn and William Taylor on behalf of several Bell Operating Companies (BOCs). In particular, I have been asked to respond to the portion of the Declaration (Section VI) in which Kahn and Taylor allege that there are no anticompetitive effects from the special access pricing of the BOCs. Although I also disagree with other aspects of their Declaration, this statement will focus only on the issue of whether the BOCs have been able to erect anticompetitive pricing structures for special access services.

My declaration will be organized as follows. Section III will review Drs. Kahn and Taylor's position on anticompetitive pricing. Section IV will discuss the economic theory of exclusionary pricing. Section V will discuss how the conditions in the special

access market are conducive to the effectiveness of exclusionary pricing. Section VI will present two examples where the BOCs have recently set special access pricing structures that incorporate highly exclusionary features.

III. Kahn and Taylor's Position on Anticompetitive Effects of Special Access Pricing

Drs. Kahn and Taylor begin their discussion with the touchstone that price reductions are good, even if they harm competitors, so long as consumer welfare is not damaged. Then, after admitting that predatory price reductions are a danger – apparently worth "repeated emphasis" [K-T at 30] by Dr. Kahn in other writings – they allege that there is no danger that the BOCs will engage in predatory pricing in the special access market. They give two reasons. First, they state that the CLECs "have already invested heavily in facilities in major markets; [and] those facilities are not going to go away." [K-T at 31] Second, they argue that the largest owners of competing local facilities (AT&T and WorldCom) are the largest customers of special access, "and that even selective price reductions would have no anticompetitive effect on the decisions of AT&T and WorldCom to supply their own needs."[K-T at 31]

In response to AT&T's allegations that specific discount features of the BOCs' special access tariffs are anticompetitive, Kahn and Taylor present the case that these features are a beneficial feature of competitive behavior. In regard to the large discounts given for volume and term commitments, Kahn and Taylor claim that these contracts are used to minimize risk and stabilize production requirements and costs over time. They also state that long-term contracts and large penalties for early termination cannot be

harmful, because AT&T is not obliged to choose them. Kahn and Taylor accuse AT&T of wanting to "have its cake and eat it." [K-T at 32] In regard to the early termination penalties, Kahn and Taylor state that these are necessary to prevent customers with short-run demand from buying at the lower Optional Pricing Plan (OPP) price and then breaching the contract when they no longer need the volumes that they committed to.

Kahn and Taylor's position appears to rest on three fundamental points. First, price reductions are good unless proven to be bad. I agree with this general point. Second, anticompetitive pricing can succeed only if the deep price reductions are followed by "quick restoration of previously prevailing prices once the competitive three has been eliminated." [K-T at 31] Third, anticompetitive pricing will not succeed because competition in the special access market is well developed. I disagree with these last two points, and I will explain the reasons in the remainder of this Declaration.

IV. The Theory of Exclusionary Pricing

The possibility that pricing practices of dominant firms can be exclusionary or anticompetitive has recently been explored in the economics literature and litigated in several antitrust cases. The distinction between exclusionary and predatory pricing has to do with the relationship between the average price and the relevant incremental or marginal costs. Predatory pricing generally refers to situations where entrants are deterred or smaller competitors are induced to exit by a dominant firm's below-cost pricing in a single market. The dominant firm then expects to "recoup" those losses with

future monopoly prices.[1] The test most commonly used for predatory pricing is that prices must be below marginal cost.

Exclusionary pricing refers to circumstances where entry is deterred or exit induced by the dominant firm's price structure. Commonly used forms of exclusionary pricing are:

1) Quantity discounts, individually negotiated with each customer, where the discount is paid back to the "first dollar" when the designated quantity is met.
2) Market share discounts which reward a customer that purchases a required percentage of its requirements from the dominant firm, but no discount if this requirement is not met. At the extreme, these discounts can provide incentives for a customer to deal exclusively with the dominant firm.
3) Purchase growth discounts
4) Liquidated damages far above the dominant firm's actual costs of discontinuing service, which are paid if the customer switches to a competitor or fails to meet minimum quantity commitments.[2]

A dominant firm is much more likely to engage in exclusionary pricing than predatory pricing, because it does not require the dominant firm to ever set price below its own costs. With exclusionary pricing, the price structure can be adjusted so that the revenues lost on the "at play" products are made up by higher prices on the quantities not in play.

[1] Losses could be recouped from future monopoly prices in the market where the monopolist predates or in other related markets if the predation enhances its ability to charge monopoly prices in those markets in the present or future through, for example, "reputation" effects.
[2] The dominant airline CRS vendors chose this strategy, with excessive fees for removing their hardware from a travel agent's premises when the agent switched to another CRS system.

As a result, exclusionary pricing is a far more rational anticompetitive strategy than predatory pricing for a dominant firm.

Formal models of exclusionary pricing have been described in the economics literature. In a seminal article published in 1991, "Naked Exclusion," Rasmusen, Ramseyer and Wiley ("RRW") present a model where a monopolist induces enough buyers to sign exclusive contracts, such that there is insufficient demand available to other firms to enable them to enter the market and operate profitably.[3] The exclusion is "naked," meaning that it is "unabashedly" meant to exclude rivals and for which there is no efficiency justification. As I will explain below, exclusionary pricing can be virtually costless to a monopolist.

The RRW model overcomes the traditional "Chicago School" objection to theories of exclusionary pricing.[4] These critics argued that a monopolist could not induce buyers to accept an exclusionary contract unless it compensated them for the loss they experienced relative to the price that would prevail in a competitive market. Since as a matter of economic theory, consumers lose more from a monopoly than the monopolist gains, such exclusion could not be profitable. The RRW model shows that in a market where the entrant must obtain a substantial market share to achieve economies of scale, the monopolist need only sign up some of the customers to convince its potential rival not to enter the market. This limits the monopolist's cost and makes exclusion a profitable strategy. What is most significant is that the monopolist does need to recoup these losses

[3] Eric B. Rasmusen, J. Mark Ramseyer, and John S. Wiley, Jr., "Naked Exclusion," *American Economic Review*, December 1991, pp. 1137-45. Subsequent articles on the same topic include: Ilya R. Segal and Michael D. Whinston, "Naked Exclusion: Comment," *American Economic Review*, March 200, pp. 296 – 309; Robert Innes and Richard J. Sexton, "Strategic Buyers and Exclusionary Contracts," *American Economic Review*, June 1994, pp. 566-84.

[4] Robert Bork, *The Antitrust Paradox: A Policy at War With Itself*, New York: Basic Books, 1978.

as it would if it were setting prices below its own costs in a conventional predatory attack.

Less than fully exclusive contracts can similarly be exclusionary where they tie up sufficient volume to prevent smaller competitors from achieving minimum viable scale. Asymmetry is critical to successful exclusion in this case – that is, customers must be unwilling or unable, to deal entirely with an entrant or fringe player for all their requirements.[5] When that is the case, the dominant firm can leverage its monopoly over the customers' basic demand (where the competitor is not a viable option) to raise substantially the costs of dealing with the competitor. The key to successful exclusionary pricing is to condition the pricing on the monopoly portion of the customer's demand on the choices the customer makes for the competitively sensitive portion of demand. The customer then pays a higher price on the monopoly demand if he deals with a competitor on the competitively sensitive demand.

Other discounts may also have the same effect. The important thing is that the customer be faced with the risk of a substantial (usually lump sum) penalty when dealing with a competitor to the dominant firm. The competitor then has to compensate the customer for this penalty (often the loss of a first-dollar discount or rebate). The exclusion works, and is very effective, because the required compensation is a real cost to the entrant of making a sale. For the dominant firm, the cost of the rebate or discount plan can be essentially zero.

To illustrate this point, I will provide a hypothetical example. Suppose the monopoly (pre-entry) price is $1.00 and the customer buys 100 units. Further suppose

[5] In addition, customers who could vertically integrate or sponsor the entry of others via long term contracts must believe that these options are not feasible for their entire requirements.

that a competitor is capable of providing 25 units at a price of 99 cents, thereby threatening to undercut the monopolist. In response, the monopolist could offer the customer the choice of buying 75 units at $1.05 per unit, or buying all 100 units for 99 cents per unit. As a result, the customer now faces a price from the monopolist for the 25 "in play" units of $20.25, or 81 cents per unit. The competitor is unable to meet this price, and is excluded from the market.

Since non-monopolists use the type of contracts discussed above, it would not be appropriate to view them as *per se* anticompetitive and illegal. Rather, conditions in the industry and specific contracts must be examined to assess the likelihood that a dominant firm is engaged in anticompetitive conduct.[6] In response to an efficiency defense given by the dominant firm in an industry where conditions are conducive to anticompetitive conduct, it is reasonable to ask whether the efficiencies claimed could be realized with contracts that were less overtly exclusionary.

V. Features of the Special Access Market that Invite Anticompetitive Pricing

The special access market meets the conditions under which a dominant firm or firms would find it profitable to engage in anticompetitive pricing. The special access market is actually composed of many separate geographic markets in which the ILECs are dominant. Although competition has developed along some routes, the BOCs retain significant market power in large pockets of the market. This is abundantly clear from a number of pieces of evidence. First, as AT&T and other parties show, the BOCs have been able to charge supranormal rates, and lately have taken advantage of the easing of

regulatory constraints to raise rates. Second, there are significant barriers to entry and expansion by the CLECs. This point, too, is supported by evidence showing the relative size of the total costs that are sunk. What is especially important is that CLECs must make a decision whether to incur high sunk costs every time they plan to expand their network to reach another part of a metropolitan area, another BOC central office, or even another building.

Because of the large economies of scale and high sunk costs associated with building and extending a local fiber network, the BOCs have a strong incentive to use exclusionary pricing in order to prevent entry and expansion of the CLECs into new routes. As discussed in Section IV above, the economics literature models situations similar to the special access market where a new entrant must achieve scale economies or overcome other entry barriers to produce at the same cost as the incumbent firm. Where the incumbent can leverage its existing monopoly and tie up a large enough portion of consumer demand with exclusionary contracts, it may be able to protect its monopoly from competitive inroads over the long run. Moreover, contrary to the Kahn and Taylor's arguments, this form of exclusionary behavior does not require the incumbent to recoup lost profits by raising prices in the future. Rather, the incumbent can maintain these price structures over the long run, because it will still earn positive profits on each special access contract taken as a whole. Put differently, the payoff to a monopolist from successful exclusionary pricing today is a higher level of prices and profits today and in the future than would have occurred in the absence of successful exclusion.

[6] These contracts do not have exclusionary effects in a competitive environment, because each seller is able to supply a customer's entire needs. Exclusionary or anticompetitive possibilities only arise when one firm, the incumbent monopolist, can supply each customer's entire demand.

Based on economic theory and the conditions in the special access market, it is entirely rational for the BOCs to erect price structures for special access that tie up customers' demand and make it unprofitable for CLECs to extend their networks. The key feature of these exclusionary contracts is that they will set very low prices for in play demand and penalize customers very heavily for shifting traffic to CLECs.

I would also like to respond to Kahn and Taylor's argument that AT&T or WCOM would not be vulnerable to anticompetitive prices, because they are both the largest customers and largest competitive suppliers of special access services. While as a theoretical matter, it is possible for large customers or customer coalitions to thwart exclusionary behavior when they have a credible threat to compete by vertically integrating into the upstream market, demand and supply conditions in the special access market would not bring about this result.

Although AT&T and WorldCom are the largest special access customers and also the largest suppliers of competitive special access services, their demand is insufficient to overcome the economies of scale and scope that the BOCs enjoy along many local routes. The reason for this is that local networks carry all types of traffic, local and long distance, low bandwidth and high bandwidth. As networks branch out closer to the customer premises, the economies of scale and scope become even more pronounced and would not be fully realized unless a CLEC could capture a substantial share of all types of traffic. The special access traffic of a large long distance carrier is insufficient to overcome the scale economies on these thin routes. As a result, even large special access customers like AT&T and WorldCom do not have a credible threat to supply their own needs in much of the special access market.

Large long distance carriers incur the same costs as CLECs in shifting special access traffic to their own facilities or a CLEC's facilities, even where those facilities pass their customers' locations. Channel terminations to customers located in large office buildings can only be completed with the permission of building owners. The need to obtain permission from the building owners, construct building cable, and install equipment, adds an additional layer of sunk costs and time delay into the process of expanding local networks.

Therefore, contrary, to Drs. Kahn and Taylor's assertions, the fact that AT&T and WorldCom are large customers and large CLECs does not make them immune from exclusionary contracts. Entrants can only overcome the barriers to entry along these thin routes by aggregating a large amount of local, as well as long distance traffic, and neither AT&T nor WorldCom have substantial shares of the local telephone business. Hence, exclusionary contracts can influence their behavior and force them to minimize costs in the short run, even if over the long run a "coalition" of all users would be better off if competitive facilities were constructed.

VI. Evidence of Exclusionary Pricing

I have reviewed the special access contract tariffs recently filed by two BOCs pursuant to the FCC's Pricing Flexibility Order. I have also discussed with WorldCom executives the negotiation process that the BOCs and WorldCom engaged in prior to the filing of these tariffs. Both of these tariffs contain provisions that do not increase consumer welfare and seem to have no other purpose other than to exclude competitors.

a. Bell South Pricing Flexibility Tariff

Bell South introduced a new pricing flexibility tariff in October 2001.[7] This tariff provides a new schedule of discounts on Special Access services in the Pricing Flexibility MSAs. The main feature of the tariff is a substantial (up to 67%) discount on growth traffic. The discount offering is for three years, although failure to achieve the thresholds leads to automatic cancellation of the eligibility of the customer for further discounts under the tariff. The discounts provided under this new tariff are supplemental to all of the existing volume, term and other discounts. The actual percentage discounts are applied to the base rates charged for the services, prior to the application of any other discounts.

The combined effect of the discount packages made available by Bell South is staggering. As shown in the table below, the undiscounted price of a ten-mile DS1 circuit is $397.50. Preexisting discounts reduce the price by about 41% to $235.00. In the first year of the tariff, the additional discounts reduce prices by $266.33, which is additional 67%, off of the original price. The final incremental price to the customer for the growth traffic is a credit of $31.15.

DS1 under ACP Plan B - Year 1

	USOCs	*M to M Rate*	*ACP Rate*	*ACP Benefit*	*TSP*	*Annual Incentive +Product Suite*	*Total Benefit*	*Actual Cost*
Interoffice Mileage	1L5XX	$247.50	$140.00	$107.50	$17.33	$165.83	$290.65	-$43.15
Channel Termination	TMECS	$150.00	$123.00	$27.00	$10.50	$100.50	$138.00	$12.00
TOTAL		**$397.50**	**$263.00**	**$134.50**	**$27.83**	**$266.33**	**$428.65**	**-$31.15**

[7] Bell South Telecommunications, Tariff F.C.C. No. 1, ¶21.

DS1 under ACP Plan B - Year 2

	USOCs	*M to M Rate*	*ACP Rate*	*ACP Benefit*	*TSP*	*PFLEX*	*Total Benefit*	*Actual Cost*
Interoffice Mileage	1L5XX	$247.50	$140.00	$107.50	$21.04	$168.30	$296.84	-$49.34
Channel Termination	TMECS	$150.00	$123.00	$27.00	$12.75	$102.00	$141.75	$8.25
TOTAL		**$397.50**	**$263.00**	**$134.50**	**$33.79**	**$270.30**	**$438.59**	**-$41.09**

DS1 under ACP Plan B - Year 3

	USOCs	*M to M Rate*	*ACP Rate*	*ACP Benefit*	*TSP*	*PFLEX*	*Total Benefit*	*Actual Cost*
Interoffice Mileage	1L5XX	$247.50	$140.00	$107.50	$24.75	$168.30	$300.55	-$53.05
Channel Termination	TMECS	$150.00	$123.00	$27.00	$15.00	$102.00	$144.00	$6.00
TOTAL		**$397.50**	**$263.00**	**$134.50**	**$39.75**	**$270.30**	**$444.55**	**-$47.05**

TSP discount year 3 (Year 1) =7%, year 4=8.5%, year 5=10%
Assumed 10 miles average on DS1

The most significant aspect of this tariff is that the discount is precisely targeted at the growth traffic of the customer. The customer receives no discount if the traffic does not reach the target, and receives the discount only on the growth traffic itself. This has an anticompetitive effect in this market, because entry is not feasible everywhere. By linking the price charged for circuits where there is no competition to the price charged for circuits where competition or entry is likely, Bell South has prevented the development of a more competitive market. According to WorldCom executives, Bell South was insistent on setting a high growth target for the discount. This had the effect of significantly reducing the payoff to WorldCom of expanding its own local network, shifting traffic to CLECs, or grooming circuits to make more efficient use of its own network.

b. SBC's MVP Tariff

In 1999, SBC introduced the Managed Value Plan ("MVP") tariff for interstate special access services.[8] MVP provides customers with discounts for maintaining a predetermined annual recurring revenue commitment for five years. The minimum average revenue commitment ("MARC") under the plan is determined based on the customer's previous three month's spending on all eligible special access services. The customer may not commit to a lower amount when it first signs up for MVP, nor may it lower the MARC at any time during the five-year commitment period. The customer has the option to increase the MARC over time as its usage increase, but once increased, the MARC may not be lowered.

The discounts available under the MVP tariff begin at 9% the first year and increase each year until they reach 14% in the fifth and final year. The discount is applied to <u>all</u> revenues covered by the agreement. If the customer fails to meet the MARC it may either pay the difference between its actual charges and the MARC, or terminate the MVP Agreement and pay penalties. Moreover, if the customer misses its commitment by 5% or more, its Agreement will be voided and it must pay the steep termination liabilities. This requirement to maintain a 95% Access Services Ratio also gives the customer a huge incentive to maintain purchases of services that are not covered under the MVP at the time of the initial subscription to the service, but which are added at a later date.

SBC's MVP tariff fits the pattern of an exclusionary contract. The discounts are tied to maintaining traffic on SBC's network, and create a very large hurdle for

competitors to overcome. Even prior to signing up for the MVP, a special access customer would have to be given a substantial discount by a CLEC to switch traffic away from SBC. For example, a customer that shifted 20% of its traffic to a CLEC would have to be given discounts ranging from 45% to 70% over the life of the contract, as shown in the table below. Once the special customer signed onto the MVP, it would be virtually impossible for the CLEC to offer a discount large enough to overcome the onerous termination liabilities.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
MVP discount	**9%**	**11%**	**12%**	**13%**	**14%**
Discount CLEC must offer on 20% of customer's traffic	**45%**	**55%**	**60%**	**65%**	**70%**

VII. Conclusion

Based on the evidence I have reviewed, I believe the FCC must reimpose price cap regulation on special access services. Competition has not developed sufficiently in most segments of the special access market to prevent the ILECs from exercising market power. The ILECs are now beginning to use their new found freedom under the Pricing Flexibility Order to engage in exclusionary behavior. This has long term implications for the market, because if the ILECs are not constrained, they will discourage competitors from making the investments necessary to challenge their market dominance.

[8] See, for example, Southwestern Bell Telephone Company Tariff F.C.C. No. 73.

Special access rates must be regulated to prevent customers from being held hostage by the ILECs. Because customers have no alternatives for a large share of their business, discounts on growth or other in play demand should not be tied to discounts on other noncompetitive portions of business. This does not mean that the ILECs should not be allowed to offer discounts, but rather these discounts should come without strings attached. Setting these constraints is an important role for regulators in a market that is undergoing a slow transition to greater competition.